

Message Text

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INFO OCT-01 EA-11 ISO-00 AGR-20 CEA-02 CIAE-00 COME-00

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FM AMEMBASSY LONDON

TO SECSTATE WASHDC 2428

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AMEMBASSY BRUSSELS

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DEPARTMENT PASS TREASURY AND FRB

E.O. 11652:N/A

TAGS:ECON, UK

SUBJECT: MINI-BUDGET: AN ASSESSMENT

REF: LONDON 9226

BEGIN SUMMARY: CHANCELLOR HEALEY'S MINI-BUDGET OF JULY 22,

IS LITTLE IN IT THAT IS DESIGNED TO MEET THE LONGER TERM

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PROBLEMS OF THE ECONOMY. ITS EFFECT ON INFLATION WILL BE

TO REDUCE PRICE RISES IN THE NEXT FEW MONTHS, BUT ITS EVENTUAL STIMULATION OF DEMAND, MILD AS IT IS, COULD OFFSET THIS IN THE LONGER RUN. IT MAKES TENTATIVE GESTURES TO BUSINESS BUT DOES NOTHING TO GET AT THE MAJOR PROBLEMS OF BUSINESS CONFIDENCE AND INVESTMENT. SHOULD ITS OBJECTIVE BE FULFILLED, I.E. THE RETURN OF LABOUR WITH A MAJORITY GOVERNMENT, AN AUTUMN BUDGET, WITH MORE DRASTIC MEASURES, WILL MOST LIKELY BE FORTHCOMING. END SUMMARY

1. THE MINI-BUDGET OF JULY 22 IS CLEARLY AN INTERIM MEASURE TO GET THE LABOUR GOVERNMENT PAST AN AUTUMN ELECTION AND BACK WITH A MAJORITY. ITS MAIN EMPHASIS IS ON INFLATION, THE MAJOR POLITICAL ISSUE AT PRESENT, AND IT ATTACKS INFLATION THROUGH THREE MAIN POLICY CHANGES:

I. A REDUCTION IN VAT FROM 10 TO 8 PERCENT. THE PRICE OF GASOLINE WILL BE REDUCED ALSO, BY 1 PENNY (ABOUT 2 PERCENT OF THE RETAIL PRICE);

II. RELIEF IN THE FORM OF REBATES FOR PROPERTY TAX PAYERS WHOSE TAX RATES HAVE RISEN MORE THAN 20 PERCENT;

III. FURTHER FOOD SUBSIDIES, PARTICULARLY ON FLOUR.

2. THESE MEASURES WILL HAVE AN IMMEDIATE EFFECT ON THE RATE OF PRICE INCREASES. HEALEY ESTIMATES THAT THE IMPACT ON RETAIL PRICES WILL BE 1.5 PERCENT IN THE NEXT 3 MONTHS, AND THE ULTIMATE EFFECT 2.5 PERCENT. THUS, RETAIL PRICES WHICH INCREASED IN JUNE BY 1 PERCENT AND OVER THE LAST 12 MONTHS BY 16.5 PERCENT WILL SLOW THEIR RAPID RISE, FOR AWHILE.

3. THIS HAS SECOND AND THIRD-ROUND EFFECTS IN THE SENSE OF ITS IMPACT ON WAGES. THE "THRESHOLD" (ESCALATOR) CLAUSE IN MOST LABOR CONTRACTS HAS BEEN TRIGGERED 6 TIMES THIS YEAR FOR A WEEKLY WAGE INCREASE OF 2.40 POUNDS FOR COVERED WORKERS. (THE THRESHOLD, BROUGHT INTO STAGE 3 WAGE/PRICE PROGRAM BY THE CONSERVATIVE GOVERNMENT LAST OCTOBER ALLOWED A 40 PENCE INCREASE WHEN THE RETAIL PRICE INDEX (RPI) REACHED 7 PERCENT ABOVE ITS OCTOBER 1973 LEVEL AND 40 PENCE FOR EACH PERCENTAGE POINT ABOVE THAT. THE RPI NOW STANDS AT 12.6 PERCENT ABOVE ITS OCTOBER 1973 LEVEL.) SLOWER PRICE INCREASES WILL MEAN LESS THRESHOLDS, THUS LIMITED OFFICIAL USE

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LESS WAGE ESCALATION. HEALEY STATED THAT THE MINI-BUDGET MEASURES SHOULD PREVENT AT LEAST ONE--AND MAYBE TWO--THRESHOLDS.

4. HEALEY MADE CURSORY BOWS TO BUSINESS WORRIES BY UPPING THE DIVIDEND LIMIT FROM 5 PERCENT TO 12-1/2 PERCENT AND BY DOUBLING THE REGIONAL EMPLOYMENT PREMIUM, ROUGHLY FROM 1 POUND 50 PENCE TO THREE POUNDS PER WORKER PER WEEK.

BOTH OF THESE MEASURES ARE DESIGNED TO EASE THE PRESSURE ON COMPANY LIQUIDITY AND SPUR INVESTMENT, THE FIRST BY ALLOWING HIGHER RETURN TO STOCKHOLDERS, THE SECOND BY INCREASING THE GOVERNMENT SUBSIDY TO INDUSTRIES IN DEVELOPMENT REGIONS (THOSE WITH HIGH UNEMPLOYMENT).

5. HEALEY ALSO PROVIDED MORE INSURANCE ON THE BALANCE OF PAYMENTS AND EXCHANGE RATE BY ANNOUNCING A LINE OF CREDIT WITH IRAN OF \$1.2 BILLION IN THREE LOANS FOR UK PUBLIC SECTOR BORROWERS. TERMS ARE TO BE CURRENT MARKET RATES, PROBABLY A FLOATING RATE WITH A MATURITY JUST UNDER FIVE YEARS.

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6. COMMENT: THE UK FACES A MYRIAD OF PARADOXICAL ECONOMIC PROBLEMS: WEAK DEMAND IN CERTAIN SECTORS; IN OTHERS THERE IS STRONG DEMAND WITH TOO LITTLE CAPACITY; RISING UNEMPLOYMENT BECAUSE OF NO GROWTH IN TOTAL PRODUCTION AND RISING UNIT COSTS; LOW INDUSTRIAL CONFIDENCE AND INVESTMENT; A SQUEEZE ON COMPANY LIQUIDITY; AND A RAPIDLY ACCELERATING INFLATION RATE. OTHER THAN THE SHORT TERM LIMITED OFFICIAL USE

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EFFECTS MENTIONED ABOVE, THE MINI-BUDGET DOES LITTLE TO MEET THE PROBLEMS.

7. OVERALL DEMAND IS SOFTENING BUT THE DURABLE GOODS INDUSTRY AND CONSTRUCTION ARE THE MAJOR SUFFERERS AT THIS TIME. THE PINCH COMES FROM REDUCED PURCHASING POWER (THE OIL PAYMENT DRAIN, HIGHER PRICES, LOWER REAL WAGES) AND FROM RESTRICTIVE CONSUMER CREDIT POLICIES INSTALLED IN DECEMBER 1973 BY THE FORMER GOVERNMENT. RETAIL SALES AND CONSUMER EXPENDITURES HAVE BEEN FALLING STEADILY SINCE MARCH, HITTING MAINLY THE DURABLE SECTORS. THE MINI-BUDGET DOES NOT REALLY GET AT THIS PROBLEM.

8. SOME SECTORS OF INDUSTRY ARE OVERSTRAINED, E.G., CAPITAL GOODS AND CHEMICALS. THE MINI-BUDGET DOES LITTLE IN THE SHORT RUN TO ALLEVIATE THE STRAIN, THOUGH DIVIDEND RELAXATION AND REGIONAL EMPLOYMENT PREMIUM INCREASE MAY HELP IN THE LONG RUN. EVEN A MILD STIMULATION OF DEMAND / COULD EXACERBATE THE CAPACITY PROBLEM IN THESE INDUSTRIES IN THE NEXT FEW MONTHS HOWEVER, AND THIS COULD SPILL OVER INTO IMPORTS AND PRICES IN THE LONGER RUN.

9. MR. HEALEY'S NOD TO INDUSTRY VIA THE DIVIDEND RELAXATION AND REGIONAL EMPLOYMENT PREMIUM WILL NOT SUFFICE TO RESTORE BUSINESS CONFIDENCE OR INVESTMENT INTENTIONS. COMPANIES EXPECT A LIQUIDITY SQUEEZE AS COSTS (MAINLY WAGES NOW -- OFFSET TO SOME EXTENT RECENTLY BY FALLING COMMODITY PRICES) RAPIDLY RISE AND PRICE CONTROLS PREVENT THEIR BEING FULLY OR QUICKLY PASSED ON. MOREOVER INDUSTRY IS UNCERTAIN OF THE ECONOMIC FUTURE AND MORE UNCERTAIN OF THE POLITICAL FUTURE. LABOR MINISTERS SUCH AS INDUSTRY MINISTER BENN REFLECT AND LOUDLY VERBALIZE A BELIEF IN A LARGE PART OF THE LABOR PARTY THAT FURTHER NATIONALIZATION AND GOVERNMENT CONTROL OF INDUSTRY IS NECESSARY AND

FEASIBLE.

10. UNEMPLOYMENT IS A GROWING PROBLEM AND MAY BECOME A MAJOR ONE BY THE END OF THIS YEAR OR MID-1975. UNEMPLOYMENT WAS 2.1 PERCENT PRIOR TO THE INDUSTRIAL CRISIS OF DECEMBER 1973-MARCH 1974. IT HAS NOT RETURNED TO THAT LEVEL DESPITE THE RECOVERY. IT LEVELED OFF AT 2.4 PERCENT LIMITED OFFICIAL USE

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AND IS NOW RISING AGAIN. THIS REFLECTS THE WEAKENING OF DEMAND IN CERTAIN SECTORS AND THE LACK OF GROWTH OF OUTPUT AS A WHOLE. IT MAY ALSO REFLECT A SHAKING OUT OF

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LABOR FORCES. WE HEAR INCREASING TALK OF EMPLOYERS SETTING WAGE BILL TARGETS (OR UNIT COST LIMITS); IF FORCED TO AGREE TO LARGE WAGE INCREASES, THEY WILL PRUNE THEIR LABOR FORCE TO MEET THOSE TARGETS. GIVEN THE PROSPECT FOR FURTHER WAGE RISES - THROUGH THE ESCALATOR CLAUSE AND AS STAGE 3 TERMINATES - THIS PROCESS IS LIKELY TO QUICKEN. THE MINI-BUDGET DOES LITTLE TO ALLEVIATE UNEMPLOYMENT EXCEPT INsofar AS INCREASED REGIONAL EMPLOYMENT PREMIUM

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INDUCES HIGHER OUTPUT AND HIGHER EMPLOYMENT IN THE DEVELOPMENT REGIONS. SINCE THESE REGIONS HAVE UNEMPLOYED RESOURCES, THIS SHOULD NOT BE INFLATIONARY.

11. ASIDE FROM THE SHORT-RUN IMPACT MENTIONED ABOVE, THE MINI-BUDGET DOES LITTLE TO GET AT THE MAJOR PROBLEM OF INFLATION. BUT THERE IS LITTLE TO BE DONE IN THIS REGARD EXCEPT TO LIMIT WAGES OR INCREASE PRODUCTIVITY. PRESENT ACCELERATING INFLATION IS IN PART THE RESULT OF THE EXCESS DEMAND SITUATION OF 72/73 (WITH THE LARGE INCREASES IN THE MONEY SUPPLY), THE COMMODITY PRICE BOOM, THE OIL PRICE RISES AND CONCOMITANT RISES IN PRICES OF ALL PETROLEUM AND ENERGY-RELATED PRODUCTS AND SERVICES, THE COAL PRICE RISE AND CONCOMITANT RISE IN THE PRICE OF COAL-RELATED PRODUCTS AND SERVICES, AND THE RISE IN PRICES THROUGH THE ESCALATOR CLAUSE IN MOST LABOR CONTRACTS. TO THE EXTENT MONDAY'S MEASURES HAVE INFLUENCED PRICES IN THE SHORT RUN, THE BUDGET DOES ALLEVIATE INFLATIONARY TENDENCIES. THE EVENTUAL DEMAND STIMULUS COULD OFFSET THIS OPENING IMPACT ON PRICES IN THE LONGER RUN. HOWEVER, THE STIMULUS IS MILD. THE REAL PROBLEM LIES BEYOND THRESHOLD AGREEMENTS AND STAGE 3 (WHICH TERMINATE IN OCTOBER): IN THE AUTUMN, WAGE CONTRACTS FOR MOST BRITISH WORKERS ARE UP FOR RENEGOTIATION. THERE ARE ALREADY MANY RUMORS OF INCREASES OF 20-25 PERCENT AGREED TO AND READY TO BE SIGNED ON THE EXPIRATION OF STAGE 3. MR. HEALEY AND OTHER LABOR GOVERNMENT MINISTERS INCREASINGLY POINT TO THE "SOCIAL COMPACT," ALMOST PLEADING THAT IT NOT BE IGNORED. THERE IS INCREASING EVIDENCE THAT IT WILL--AT LEAST AFTER THE ELECTION.

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